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## OIL AND GAS

by

Richard W. Hemingway\*

AS in previous *Survey* issues, this Article includes only those cases and other developments from Texas during the preceding year that are significant. Recent developments in the following areas are examined: the mineral estate, including cases dealing with the relationship of the mineral estate to the surface estate; oil and gas leases; regulation cases; miscellaneous cases; and legislation.

### I. THE MINERAL ESTATE

*Lomax v. Henderson*<sup>1</sup> presented a question involving condemnation of the mineral estate where, under simplified facts, the surface and one-half of the minerals in a 200-acre tract of land were owned by *A*, and the remaining one-half mineral interest was owned by *B*. *B* owned no adjacent tracts of land. The condemnor was awarded

[f]ree simple title in and to the [200 acres], except that defendants shall retain all oil, gas, and other minerals in, on, or under said land, it being provided, however, that no operations for the recovery of any such oil, gas, and other minerals shall be conducted on the surface of said premises.<sup>2</sup>

The condemnation judgment awarded \$120,000 to *A* and *B* without apportionment, "with division of said sum to be in accordance with the order of the Court to be entered at a later date."<sup>3</sup> *A* filed a motion asserting a right to all of the award as the owner of the surface of the land. *B* intervened, alleging damages caused by the condemnation. The court awarded all of the money to *A* on the dual ground that (1) none of the oil, gas, or mineral interest was condemned under the award, and (2) the minerals that might be produced from the condemned property had no reasonable cash market value. *B* appealed as to both grounds.

The court of appeals affirmed the judgment on the ground that the trial court's finding that *B*'s mineral estate had no reasonable cash market value was not contrary to the great weight and preponderance of the evidence. The appellate court stated that although none of the mineral estate was actually condemned, *B* would be entitled to compensation for the loss of

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1. 559 S.W.2d 466 (Tex. Civ. App.—Waco 1977, writ ref'd n.r.e.).

2. *Id.* at 466 (condemnor was the Brazos River Authority).

3. *Id.* at 467.

the use of the surface estate for development of the mineral estate. The court held that the measure of this loss was the diminution of the value of the mineral estate caused by the taking of the surface. Since expert testimony established that any market value placed on the mineral estate would be both nominal and speculative, *B* was not entitled to an award. The dissent, on the other hand, believed that previous decisions upholding a right to compensation for interference with the use and enjoyment of land required that *B* be compensated for his loss.

Imprecise draftsmanship of a deed containing a reservation of a mineral interest led to litigation over the ownership of bonus in *Houston v. Moore Investment Co.*<sup>4</sup> The deed from Moore to Houston contained the following reservations:

There is reserved and excepted from this conveyance, and Grantor hereby retains the title to, an undivided one-half interest in all oil, gas or other minerals in, on or under the lands hereinabove described, but the Grantee herein shall have the right and privilege of executing an oil, gas and mineral lease on such land, without the joinder of Grantor, with the understanding that any such lease shall provide for a royalty to the owners of the land in an amount not less than one-eighth of the minerals to be produced from said land, and further provided that Grantor shall be entitled to one-half of any such royalties retained in such lease.<sup>5</sup>

Houston argued that because the deed expressly mentioned Moore's right to one-half of the royalties retained in any lease, by implication the right to bonus had been excluded.

The court of appeals affirmed the trial court's holding that Moore was entitled to one-half of the bonus. Because the grantor surrendered only one incident of ownership, the right to execute an oil, gas, and mineral lease, no other rights incident to the reserved mineral interest were affected. The court held that the recital was not a sufficiently clear expression of the parties' intention to warrant modifying the reserved mineral interest.<sup>6</sup> Moore, therefore, was entitled to one-half of bonuses, royalties, and rentals. The court further held that the failure of the recital to mention bonuses or rentals did not make the deed ambiguous.

In *Haddad v. Boon*<sup>7</sup> the court applied the rule of *Duhig v. Peavy-Moore Lumber Co.*<sup>8</sup> to a case involving a reserved royalty in a deed. Walker conveyed a tract of land to the Veterans' Land Board of Texas, reserving an undivided 1/16 royalty interest. The Veterans' Land Board in turn had conveyed to Boon, excepting Walker's 1/16 royalty interest. Defendant

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4. 559 S.W.2d 850 (Tex. Civ. App.—Houston [1st Dist.] 1977, no writ).

5. *Id.* at 851-52.

6. The court distinguished *Benge v. Scherbauer*, 152 Tex. 447, 259 S.W.2d 166 (1953), in which the parties had modified the reserved mineral interest by clearly expressing their intention to do so.

7. 557 S.W.2d 805 (Tex. Civ. App.—Amarillo 1977, no writ).

8. 135 Tex. 503, 144 S.W.2d 878 (1940). See also R. HEMINGWAY, *THE LAW OF OIL AND GAS* § 3.2 (1971); Hemingway, *After-Acquired Title in Texas* (pt. 2), 20 Sw. L.J. 310, 321 (1966).

Boon subsequently conveyed the tract to defendant Jones, reserving a 1/32 royalty interest, without mention or exception of the 1/16 royalty reserved to Walker. Jones executed a conveyance of the land to plaintiff Haddad without reservation or exception of either the 1/16 or 1/32 royalty interests. All parties agreed that they were bound by Walker's 1/16 royalty reservation. The question presented was whether Boon retained ownership of the 1/32 royalty interest. The trial court granted defendant Boon's motion for summary judgment.

The court of appeals found the doctrine of the *Duhig* case applicable: when there is an overconveyance in a deed with a reserved interest, so much of the reserved interest will be taken from the grantor as is necessary to make the grantee whole. On this ground Haddad should have prevailed as the owner of all royalty except the 1/16 reserved to Walker. Hence, the summary judgment in Boon's favor was erroneous. Nevertheless, the court of appeals did not render but remanded on the ground that the trial court had not ruled on Boon's attempt to reform the deed to show the exception of Walker's 1/16 royalty interest in addition to Boon's reserved 1/32 royalty interest. Reformation would have rendered the *Duhig* rule inapplicable.

*Haddad* is of interest because it is one of the few cases that have attempted to apply the *Duhig* rule to reservations of a royalty interest. In *Continental Oil Co. v. Doornbos*<sup>9</sup> the appellate court in effect applied the *Duhig* rule to a case involving reformation. This decision was reversed by the supreme court on the ground that the alternative relief of construction of the deed had not been requested; therefore, the application of the *Duhig* rules was improper, being a switch from the "equitable principles of reformation to legal rules of construction half way through the solution of the controversy."<sup>10</sup>

*McClung v. Lawrence*<sup>11</sup> was another case that applied the *Duhig* rule to a reserved royalty interest. The supreme court indicated that although the application of the *Duhig* rule to reserved royalty interests is proper, whenever reformation is sought as an alternative ground the case should be remanded to determine if reformation is justified. *Lawrence* was cited as authority in *Haddad*.

*Amoco Production Co. v. Braslau*<sup>12</sup> addressed the question whether a term royalty interest that was beyond the term terminated due to stoppage in production under the oil and gas lease caused by the collapse of a casing. Production ceased for some three months. When the lessee could not again obtain production, he completed in another reservoir. The trial court held that because the cessation was temporary the term interest did not terminate. The court of appeals reversed on the ground that stoppage of production in the original reservoir with completion in a new reservoir

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9. 386 S.W.2d 610 (Tex. Civ. App.—Beaumont 1964), *rev'd*, 402 S.W.2d 879 (Tex. 1966).

10. 402 S.W.2d 879, 883 (Tex. 1966).

11. 430 S.W.2d 179 (Tex. 1968).

12. 561 S.W.2d 805 (Tex. 1978).

was not temporary cessation.<sup>13</sup>

The supreme court reversed and affirmed the holding of the trial court. The court pointed out that in drilling the well four sands were encountered, *A, B, C, and D*. The original completion was made in sands *B* and *D*. After the casing collapsed, lessee completed in sand *C*. The court stressed that the case did not concern cessation of production during a period of further or deeper exploration, as all sands were encountered during the original drilling. In holding that the cessation was temporary, during which time the term royalty interest did not terminate, the court cited the cases of *Midwest Oil Corp. v. Winsauer*<sup>14</sup> and *Stuart v. Pundt*,<sup>15</sup> but distinguished them because neither case concerned production in new strata.

## II. OIL AND GAS LEASES

*Habendum Clause Cases.* In *Natural Gas Pipeline Co. of America v. Zimmer*<sup>16</sup> the federal district court in Amarillo considered another case involving an oil and gas lease with a fixed term. The habendum clause provided that the lease would remain in effect for a twelve-year primary term and as long thereafter as oil or gas was produced from the land, with the proviso that "this lease shall not remain in force longer than fifty (50) years from this date."<sup>17</sup> The lease was dated January 16, 1926.

On April 5, 1935, the parties entered into a supplemental agreement extending for one year the time in which a well might be commenced,<sup>18</sup> and further agreed that one well would constitute adequate development of natural gas production over the entire 1,280 acres. The agreement continued that "said oil and gas lease shall remain in full force and effect as to all the land included within said 1,280 acres, *so long as oil or gas is produced from any portion thereof*."<sup>19</sup>

The question involved was whether the last quoted language in the agreement was sufficient to modify the original lease so as to remove the fifty-year limitation. The court considered the lease and supplemental agreement as a whole and held that the language did not extend the lease beyond the original fifty-year term. Citing *Gulf Oil Corp. v. Southland Royalty Co.*,<sup>20</sup> which involved the same lease form, the court stated that "the habendum clause traditionally controls unless properly modified by other provisions, and the fixed term therein stated is not to be extended by words found elsewhere in the lease not certainly directed to the modifica-

13. The court of appeals case, *Braslau v. Amoco Prod. Co.*, 549 S.W.2d 260 (Tex. Civ. App.—Corpus Christi 1977), was discussed in Hemingway, *Oil and Gas, Annual Survey of Texas Law*, 32 Sw. L.J. 163, 170 (1978).

14. 159 Tex. 560, 323 S.W.2d 944 (1959).

15. 338 S.W.2d 167 (Tex. Civ. App.—San Antonio 1960, writ ref'd).

16. 447 F. Supp. 66 (N.D. Tex. 1977), *aff'd per curiam*, 576 F.2d 106 (5th Cir. 1978).

17. 447 F. Supp. at 67 n.1.

18. The original lease required that a well be commenced within 10 years from the date of the lease.

19. 447 F. Supp. at 68 (emphasis added).

20. 478 S.W.2d 583 (Tex. Civ. App.—El Paso 1972), *aff'd*, 496 S.W.2d 547 (Tex. 1973).

tion of the habendum clause."<sup>21</sup>

Although *Stephenson v. Vineyard*<sup>22</sup> is a term mineral interest case, it is included in this section because it concerns the meaning of the term "production," a term that is generally construed to have the same meaning whether found in a mineral or royalty deed or in an oil or gas lease. In *Stephenson* a mineral reservation was to take effect at the end of two years if there was no production from the property, or at the cessation of production if there was production at the end of the two years. A well that was drilled and potentialed on the property prior to the end of the two-year period indicated that production would be sufficient to prevent the reserved interest from taking effect. No gas was sold, however, until at least one month after the end of the two-year term. The appellate court held that although gas had been discovered, actual production had not begun and, consequently, the mineral interest had reverted. This is in accordance with the Texas rule that discovery is not production.

*Royalty Clause Cases.* The case of *Mitchell Energy Corp. v. Blakley*<sup>23</sup> considered whether gas sold to a drilling contractor for use in drilling a well on the leased premises constituted a sale or use "off the premises" for which royalty and shut-in royalty was payable or came within a clause providing that "Lessee shall have free use of oil, gas, coal and water from said land, except water from Lessor's wells, for all operations hereunder, and the royalty in oil, gas and coal shall be computed after deducting any so used."<sup>24</sup> In holding that the gas sold was within the free gas clause upon which neither royalty nor shut-in royalty was payable, the court emphasized that the gas was used solely in drilling operations on land under the lease and not in connection with other property. The court also noted that the royalty clause did not provide for royalty payment for gas sold for such on-premises use.

*Butler v. Exxon Corp.*<sup>25</sup> and *Exxon Corp. v. Middleton*<sup>26</sup> also involved construction of the phrase "off the premises." In *Butler* the court had to determine which of the two parts of the royalty clause governed royalty payments on gas sold into interstate commerce under twenty-year contracts of sale. The first of these parts provided, "on gas, . . . produced from said land and sold or used *off the premises* . . . , [the royalty shall be] the *market value* at the well of one-eighth of the gas so sold or used." The other clause provided, "on gas sold *at the wells* the royalty shall be one-eighth of the *amount realized* from such sale."<sup>27</sup>

Exxon sold the gas at the tailgate of a processing plant located some 100 feet beyond the lease lines. The royalty owners argued that the gas was

21. 447 F. Supp. at 70.

22. 564 S.W.2d 424 (Tex. Civ. App.—Houston [1st Dist.] 1978, writ ref'd n.r.e.). See discussion of pooling provisions involved in this case in text accompanying note 49 *infra*.

23. 560 S.W.2d 740 (Tex. Civ. App.—Fort Worth 1977, writ ref'd n.r.e.).

24. *Id.* at 743.

25. 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

26. 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ filed).

27. 559 S.W.2d at 412 (emphasis added).

thus sold "off the premises," making the market value clause applicable. They cited the *Vela* case<sup>28</sup> in support of their position and urged the court to adopt its reasoning, under which market value is determined by the day-to-day market value in the field, rather than by the amount received under the long-term gas sales contracts.<sup>29</sup> The court distinguished *Vela* on the ground that *all* gas sold from gas wells under the lease therein considered was to be paid for at the "market price" at the well. In *Butler*, however, the issue was whether a sale 100 feet outside the lease line was to be considered an "off the premises" market value sale or an "at the wells" amount realized sale.

The court of appeals expressly affirmed the following finding by the trial court:

"[T]he term 'at the wells' means gas delivery which occurs in the *vicinity* of the field of production where the wells are located, rather than at some remote location such as the other end of a gas transmission line. For a sale to be termed 'at the wells', delivery need not occur at the 'Christmas tree' on top of the well casing, *nor is there any requirement that delivery occur on the particular lease or unit from which the gas is produced.*"<sup>30</sup>

The court noted that the parties did not use mutually exclusive terms such as "on the premises" and "off the premises," or "at the well" and "away from the well." It accordingly held that a sale at the well was not limited to one made on the premises and "that a sale may occur 'at the well' even though delivery is made several hundred feet from the Christmas tree."<sup>31</sup> As to these leases, sales were made "at the well" and royalty was properly payable on the amount realized from the proceeds of sale under the long-term contracts.

In a separate lease involved in the controversy, the Veterans' Land Board lease, the only royalty clause provided for royalty based on the market value of gas "produced and saved from the leased premises."<sup>32</sup> The court of appeals held that the *Vela* case controlled and that royalty was to be based on market value as determined at the time of the delivery to the purchaser.<sup>33</sup> Chief Justice Preslar wrote a vigorous dissent directed at the majority opinion regarding the Veterans' Land Board lease. His dissent was twofold: first, "market value" should be construed as the price for which the producer sells his gas, a meaning supported by judicial construction of the term appearing in several tax statutes; second, *Vela* was distinguishable on the ground that the royalty clause in the *Vela* lease only

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28. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968).

29. The price under the long-term contracts was about 19.5¢ per mcf, whereas the market price for the intrastate sales varies from 39.5¢ per mcf to \$2.06 per mcf.

30. 559 S.W.2d at 414 (emphasis added).

31. *Id.* at 416.

32. *Id.* at 412.

33. The royalty owners had executed division orders, later revoked, that provided for settlement based on "net proceeds at the well." *Id.* Rejecting the trial court's reasoning that the orders were binding contracts until revoked, the court of appeals reached the erroneous conclusion that executing these division orders did not estop the royalty owners from claiming royalties based on market price. *Id.* at 416-17.

provided for royalty on gas "sold or used off the premises." The dissent pointed out that such a clause was normally used to distinguish the free gas used by the lessee from gas sold to the local market on a short-term or day-to-day basis. Since the Veterans' Land Board lease had no "used or sold off the premises" clause, the dissent argued that the parties must have contemplated that the clause used in the lease applied to long-term sales of total production rather than to short-term sales of gas. As to the former, the reason for fixing the price of gas by each delivery does not apply, and the price should be fixed under the long-term sales contracts.

In *Middleton* the court was dealing with the identical questions involved in *Butler*, including the same royalty clause. Part of the gas was processed at the lessee's processing plant, which was not located on lease lands, and delivered to customers at the plant's tailgate. As to these deliveries, the court concluded that gas was being "sold" when so delivered and that such sales were "off the premises," making the "market value" portion of the royalty clause applicable. As a result, Exxon was liable for the royalty/market price differential. Although the court agreed with *Butler*'s holding that market value must be determined at the date of delivery rather than at the date of the execution of the long-term contracts, the cases are squarely in conflict as to the proper interpretation of the phrases "off the premises" and "at the wells."<sup>34</sup>

The cases also are in conflict on the question whether division orders expressly committed to "the life of the lease" are supported by consideration or are unilaterally revocable by the lessors. In *Middleton* the court held that the division orders, which changed the royalty obligation from payment based upon market value to payment based upon the proceeds received by the lessee, were supported by consideration and, hence, were revocable only by mutual consent.

*Middleton* included a detailed discussion of the manner in which market value should be computed. The case was remanded because the expert testimony upon which the market value had been based did not comply with the guidelines set forth in *Vela*. The court stated that under *Vela* the following factors must be considered:

(1) the relevant marketing area is the field in which the gas was produced; (2) the market price of gas is to be determined by reference to sales of gas comparable in time, quality and availability to marketing outlets; (3) the mathematical average of all prices paid in the field is not a final answer to determining market value price at any particular time; (4) the relevant period of time to be used in determining the amount that should have been paid to the royalty owners is the specific period in question; and (5) an expert's opinion based upon a mathematical average of prices paid in the field and corroborated by comparable sales from the field during the relevant period may afford

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34. The court did apply the "sold at the wells" provision for payment of royalty under the "amount realized" clause where delivery was made to purchasers on Sun Oil lease lands and then transported off the lands before resale. 571 S.W.2d at 363-64.



a basis for determining market price.<sup>35</sup>

The court also rejected Exxon's proposition that its stated field price should control, basing its rejection on Exxon's inclusion of noncomparable sales in the computation of its field price. All sales involved in *Middleton* were intrastate, but the field price base of Exxon included interstate sales and sales to affiliates. In rejecting the inclusion of interstate sales, the court appended the following interesting footnote:

We do not believe that the Texas courts will apply the principles of *Vela* to federally controlled or regulated interstate gas, since there can be no "market value" or "market price" in a price-regulated environment, although we recognize that the supreme court did permit the consideration in *Vela* of the price of regulated gas sold to Tennessee Gas from the Lopeno Field. We also note that in 1977, FPC functions were transferred to the new Federal Energy Regulatory Commission, and the FPC was terminated. Department of Energy Organization Act, 42 U.S.C.A. §§ 7171, 7172, 7293 (Supp. 1977).<sup>36</sup>

Although the Texas Supreme Court found no reversible error in *Butler* and refused to grant writ, the serious conflicts between *Butler* and *Middleton* should prompt the court to grant writ in this more recent case.

Repercussions of *Vela* were felt yet again in *Hemus & Co. v. Hawkins*,<sup>37</sup> in which royalty owners argued that royalty payments should have been based upon the "market value" of the increased price paid for intrastate gas sales. This case involved the sale of a split stream of gas. Two lessees sold gas exclusively into the Texas intrastate market, while the defendant, Natural Gas Pipeline Company of America, sold gas in the interstate market under contracts so dedicated. The price paid for gas sold in the Texas market was greater than the price received under the long-term interstate gas sales contracts. The issue was whether under a market value royalty clause contained in a lease that bound the lessee to sell all its gas into the interstate market, sales into the intrastate market were "comparable." The lessee argued not that market value for the royalty obligation was to be determined solely by the lessee's contract in the interstate market, but that market value must be predicated upon comparable sales, which would not include sales in the intrastate market.

The court held that where gas is dedicated to interstate commerce, only sales in the interstate market are comparable. The court distinguished *Vela* because in that case market value for royalty purposes had been based on the increased price paid for current sales of gas into the interstate market. Thus, the question whether intrastate sales are "comparable" for purposes of determining the market value of gas dedicated to interstate commerce was not in issue.

The Texas Supreme Court considered another question involving royalty on interstate gas sales in *Phillips Petroleum Co. v. Stahl Petroleum*

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35. *Id.* at 362.

36. *Id.* at 362 n.3.

37. 452 F. Supp. 861 (S.D. Tex. 1978).

Co.<sup>38</sup> Phillips purchased casinghead gas from Stahl, payment for which was based on a percentage of the "weighted average price received" by Phillips from subsequent sales to third parties. Phillips was to pay Stahl not later than the last day of each succeeding month.

Prior to the Stahl contract, Phillips had applied for a rate increase from the Federal Power Commission. Pending the FPC's response, Phillips charged its customers the increased rate, subject to refund, but did not consider the price increase when calculating its payments to Stahl. After eighteen years the rate increases were partially approved and partially rejected.

Phillips filed suit for a declaratory judgment that such payments were not subject to the payment of interest; Stahl counterclaimed for interest. Phillips' theory was that prejudgment interest cannot be allowed *eo nomine* unless provided for by contract or by statute. Here the gas purchase contract did not provide for the payment of such interest, nor did it provide for the retention of any portion of a requested rate increase that might be subject to refund.

The court of appeals<sup>39</sup> reversed the trial court's judgment in favor of Phillips, finding that Stahl was paid in full. Furthermore, the court assessed interest on this sum from the date payment was made to the date of judgment, in essence forcing Phillips to pay interest on interest. The Texas Supreme Court affirmed on two grounds. The first followed the sole ground for the holding of the court of appeals, which was that interest was payable under articles 5069—1.01 and 5069—1.03 of the Texas Revised Civil Statutes.<sup>40</sup> Phillips' argument that no sum was ascertainable or due and payable until the finality of the FPC's order was not sustainable, as it was contrary to the plain wording of the gas purchase contract which contained no exceptions allowing for the withholding of funds collected pursuant to unapproved rate increases. The main point of affirmance was based on the general equitable principle "that 'Phillips ought not to be able to use someone else's money as it pleases for ten years, thereby enjoying a very considerable benefit, and then pay nothing for the use of the money,' "<sup>41</sup> a principle not even mentioned by the court of appeals. Under these circumstances the court found an equitable exception to the "interest *eo nomine*" rule.

The question that immediately comes to mind is whether the *Stahl* holding is applicable to those instances where royalty owners have funds suspended due to title matters. The court pointed out that if there were no agreement to so retain such monies without interest, then interest would be

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38. 569 S.W.2d 480 (Tex. 1978).

39. 550 S.W.2d 360 (Tex. Civ. App.—Amarillo 1977).

40. Article 5069—1.01 defines interest as including compensation allowed by law for the detention of money, and art. 5069—1.03 sets the legal rate of interest for written contracts that specify a sum payable but do not fix an interest rate for past due payments. TEX. REV. CIV. STAT. ANN. arts. 5069—1.01, .03 (Vernon 1971).

41. 569 S.W.2d at 485 (quoting *Phillips Petroleum Co. v. Adams*, 513 F.2d 355 (5th Cir.), *cert. denied*, 423 U.S. 930 (1975)).

payable to their retention. On the other hand, the court stated that in those instances where appropriate provisions allowing for the suspension of payments were contained in division orders, such provisions would prevail. This, however, should not preclude the payment of interest when payments have been retained pursuant to provisions of a division order but such retention was unreasonable under the facts.

*Delay Rental Clause.* In *Brannon v. Gulf States Energy Corp.*<sup>42</sup> the court of appeals held that parol evidence could be admitted to show that payments accompanied by a letter that referred to them as "lease rental," for a lease that had otherwise expired for nonpayment of rental, were actually bonus payments for a new lease on the same tract. Gulf States, the lessee under the new lease, had drilled several wells on the lease lands. On appeal the Texas Supreme Court reversed the holdings of both the trial court and court of appeals on the ground that the letter and check were contractual in nature, and thus parol evidence was not admissible. Thus, the letter's recital of the payment as lease rental was controlling, and the acceptance of the late delay rental payment had the effect of reviving the earlier lease. The high court also held that, under the facts, Gulf States had sufficient interest in the original leasehold estate so as not to be a stranger to the initial lease, which otherwise would have precluded the application of the parol evidence rule.

The supreme court remanded the case to determine whether Gulf States could receive recoupment of its reasonable costs and expenses as a good faith trespasser, a status that would not be precluded by its knowledge of the former lease. Gulf States did not enter upon the leasehold pendente lite, and, in fact no suit was filed prior to the spudding of its first two wells.

*Dry Hole Clause.* The only significant case in this area is that of *Chandler v. Drummet*,<sup>43</sup> which involved a lease with a ten-year primary term and a 120-day obligatory well drilling clause. The clause provided that the lease would be valid and in effect if a test well was commenced within the time period. Although a well was timely commenced, it came in dry, and the lessee did not initiate additional drilling operations within sixty days.

The problem in the case was caused by the striking of the delay rental clause from the lease without a corresponding modification of the normal dry hole clause. Under the dry hole clause the lessee was obligated within sixty days after drilling a dry hole to commence additional drilling operations, or, if within the primary term, to commence the payment of delay rentals on or before the next rental payment date. Since the lessee drilled the dry hole within the first year of the lease, he could have commenced the payment of delay rentals at the end of the first year if the delay rental clause had been retained. This option, however, was not open to the lessee. The question then became whether the lease had terminated be-

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42. 548 S.W.2d 790 (Tex. Civ. App.—Eastland), *rev'd*, 562 S.W.2d 219 (Tex. 1977). The court of appeals opinion is discussed in Hemingway, *supra* note 13, at 173.

43. 557 S.W.2d 313 (Tex. Civ. App.—Houston [1st Dist.] 1977, writ *ref'd* n.r.e.).

cause additional operations had not been begun within the sixty-day period. The lessee strongly urged: (1) that the provisions of the dry hole clause should not apply; (2) that in any event the lessee had a reasonable time to commence additional operations under the lease, which time limit would not be controlled by the dry hole clause; or, (3) that due to the drilling of the test well, the lease was in effect for the entire ten-year period.

The court reviewed the old case of *Texas Co. v. Davis*,<sup>44</sup> which held that if delay rentals were not payable a lease could be terminated if the lessee had abandoned the purpose of the lease, that is, if the lessee held for speculative purposes as opposed to development. The *Chandler* court concluded that by setting a sixty-day limit the dry hole clause eliminated any potential confusion as to what would constitute a reasonable time within which exploration must be renewed in order to prevent abandonment.

The problem in *Chandler* was caused by the parties' failure to determine sufficiently the effect of the omission of the delay rental clause. The result may or may not have been the one they intended. Nevertheless, clear draftsmanship would have prevented this needless litigation.

**Pooling Clause.** Two rather important cases were decided in Texas dealing with whether a lessee has exercised the pooling authority in good faith. The first case is *Elliott v. Davis*,<sup>45</sup> in which the court discussed extensively the nature of the relationship of the lessee to the lessor in the exercise of the pooling authority. The lessor in *Elliott* sought to cancel leases on the ground that the lessee had exercised the pooling authority in bad faith. He argued that the lessee should be treated as a trustee, whose actions must comply with a strict fiduciary standard. The court, however, defined the relationship as follows:

Although it has been said that the lessee has a fiduciary obligation in the exercise of the pooling power, it is submitted that the lessee is not a fiduciary and that standards applied to fiduciaries are entirely too strict. This is so because the lessee has not undertaken to manage and develop the property for the sole benefit of the lessor. The lessee has substantial interests that must be taken into account, and he should not be required to subordinate his own interests entirely to the interests of the lessor. Since his interests frequently conflict with those of his lessor, however, he must exercise the power in fairness and in good faith, taking into account the interests of both the lessor and lessee.<sup>46</sup>

The court further held that the failure of the Texas Railroad Commission to approve a unit or pool is not, in itself, determinative of the question of good faith. The case was remanded since a fact issue on good faith remained. The case is important because it is one of the very few that

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44. 113 Tex. 321, 254 S.W. 304 (1923).

45. 553 S.W.2d 223 (Tex. Civ. App.—Amarillo 1977, writ ref'd n.r.e.).

46. *Id.* at 226-27 (quoting 4 E. KUNTZ, THE LAW OF OIL AND GAS § 48.3, at 219 (1972)).

discusses the standard of conduct of the lessee in exercising the pooling authority.

The second case in this area, *Amoco Production Co. v. Underwood*,<sup>47</sup> applied the good faith standard outlined in *Elliott*. In *Amoco* the appellate court held that the lessee had in fact exercised the pooling authority in bad faith. By pooling, the lessee had been able to preserve a majority of his leases that would otherwise have expired, including lands upon which the evidence showed there was no probability of the lessee drilling and upon which the lessee had no plans to drill additional wells.

The clause in *Amoco* allowed pooling "when in Lessee's judgment it is necessary or advisable to do so in order to *properly develop and operate* said premises."<sup>48</sup> Within this context the court held that pooling merely to hold leases that would otherwise expire and that lessee had no plans to develop constituted bad faith. The court, however, did not comment on the common practice of including small parts of leases in a pool when they are nearing the end of their primary terms in order to prevent termination. Where it is reasonably within the contemplation of the lessee to develop the leases, such pooling would not seem to be proscribed by the opinion.

*Stephenson v. Vineyard*<sup>49</sup> concerned the question whether a reserved term royalty interest was maintained in existence after the two-year term by pooled production from an off-lease tract. Prior to conveying the land in question, the Stephensons had executed an oil and gas lease that contained pooling provisions. Additionally, the deed was expressly made "subject to" the existing lease. Within the two-year period production was obtained from lands with which the lease had been pooled. The court held that the pooled production did not inure to and perpetuate the term royalty interest.

The decision appears to be in error. The basis of the court's conclusion was that acceptance by the grantee of a deed "subject to" the lease did not have the effect of ratifying the lease. This may or may not be an accurate statement of the law, as cases in Texas have held that acceptance of such a deed has the effect of ratification.<sup>50</sup> These cases are subject to criticism, however, on the ground that the clause is primarily for the purpose of avoiding liability on the part of the grantor for breach of warranty due to the outstanding lease and not for ratification by the grantee.

Regardless, the court did not consider that at the time the lease was executed with pooling authority, the lessor was the owner of the entire mineral estate, except for an outstanding royalty interest whose owner expressly ratified the lease. The question is whether the lessor, after execution of the lease, could convey an interest not subject to the pooling authority of the lessee. In Texas, in the case of an entirety clause in a

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47. 558 S.W.2d 509 (Tex. Civ. App.—Eastland 1977, writ ref'd n.r.e.).

48. *Id.* at 511 (emphasis added).

49. 564 S.W.2d 424 (Tex. Civ. App.—Houston [1st Dist.] 1978, writ ref'd n.r.e.). This case is also discussed in the text accompanying note 22 *supra*.

50. *Humble Oil & Ref. Co. v. Clark*, 126 Tex. 262, 87 S.W.2d 471 (1935); *Van Deventer v. Gulf Prod. Co.*, 41 S.W.2d 1029 (Tex. Civ. App.—Beaumont 1931, writ ref'd).

lease, it has been held that the lessor cannot thereafter convey free from the entirety clause, that is, put the conveyed royalty interest back on a non-apportionment basis, without the joinder of the lessee.<sup>51</sup> The same result should obtain when a royalty interest is conveyed after the execution of a lease containing pooling authority and binding all interests of the grantor-lessor. When a nonparticipating royalty exists prior to the execution of the lease containing the pooling provision, a different rule prevails, and it is clear that in Texas the attempted pooling by the lessee will not bind the nonparticipating royalty owner, unless he ratifies the pooling agreement. The recent case of *Ruiz v. Martin*<sup>52</sup> contains an example of such ratification.

*Implied Covenants.* In *Wes-Tex Land Co. v. Simmons*<sup>53</sup> the assignor of an oil and gas lease requested cancellation of the assignment and damages after the assignee failed to drill an offset well to prevent drainage. In the assignment the assignor had reserved an overriding royalty interest of 1/16 of 8/8. The assignor offered proof that a reasonably prudent lessee would have drilled, in that a well drilled upon the subject land would have produced in paying quantities. The court held that the assignee impliedly covenanted to protect the premises against drainage when the assignor reserved an overriding royalty.<sup>54</sup> As a result, the assignor was entitled to the amount of royalty he would have received if the offset well had been properly drilled, at least up to the amount requested as damages. The assignor was denied cancellation on the grounds that the obligation was a covenant, not a condition, and that the assignor had not asked for an alternative, conditional decree, a prerequisite to the granting of this equitable remedy.

The proper test as to whether a reasonably prudent lessee would drill an offset well is whether the well would produce sufficiently to pay the lessee all costs and expenses of drilling, equipping, and producing the well, as well as return a reasonable profit. It is unclear in this opinion whether such potential production was shown by the evidence.

*Fiduciary Relationship.* Two cases were appealed during the past year involving the imposition of a constructive trust. They reached different conclusions in determining whether a fiduciary relationship existed and a constructive trust could be imposed.

In *Echols v. Yeates Development Co.*<sup>55</sup> the lessee acquired oil and gas leases and employed Echols to acquire additional leases for the benefit of both Echols and the lessee. Echols was also acting as an agent for the defendant lessors. The plaintiff lessee drilled a gas well that was shut in and upon which shut-in royalties were not timely paid. For a year after

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51. *Cockrell v. Texas Gulf Sulphur Co.*, 157 Tex. 10, 299 S.W.2d 672 (1956).

52. 559 S.W.2d 839 (Tex. Civ. App.—San Antonio 1977, writ ref'd n.r.e.).

53. 566 S.W.2d 719 (Tex. Civ. App.—Eastland 1978, writ ref'd n.r.e.).

54. This question was finally settled in Texas in the case of *Bolton v. Coats*, 533 S.W.2d 914 (Tex. 1975).

55. 565 S.W.2d 277 (Tex. Civ. App.—Fort Worth 1978, writ ref'd n.r.e.).

the well was shut in Echols worked with the lessee on title matters. During this time Echols knew that the lessee was spending time and money negotiating for a higher gas price and constructing a gas pipeline. Echols, however, did not inform the lessee that nonpayment of the shut-in royalties would terminate the lease. Instead he acquired new leases on the land for his own benefit.

The lessee brought suit for a judgment that the original leases had not terminated. The judgment was granted by the trial court and affirmed by the court of appeals, which held that the trial court's finding of a fiduciary relationship between Echols and the lessee was supported by the evidence. Since Echols was the defendant lessors' agent, both he and the lessors were estopped by his silence when such silence was designed to induce the lessee into further developing the lease. The court of appeals affirmed the trial court's holding that the original leases had not terminated and that a constructive trust would be imposed upon any other leases acquired by the agent and the defendants during this period. The court did not discuss the agreement or any other factors defining the fiduciary relationship between the lessee and Echols.

At issue in *Hoover v. Cooke*<sup>56</sup> was whether a fiduciary relationship existed between two independent geologists. Cooke contacted Hoover, a geologist in the employ of Southland Royalty Company, to determine whether Southland would be interested in acquiring leases in the Pearsall Field in Frio County, Texas. Finding that Southland was interested in acquiring leases, Cooke furnished Hoover with a report of the field and a method of production. Cooke had prepared the report after studying the field for a number of years and had proposed special production techniques to make production economical. The report was furnished only to those who desired to acquire leases in the field.

Cooke was unaware of an agreement between Hoover and Southland whereby Hoover could acquire for his own benefit any leases presented by him to Southland that it decided not to take. Hoover visited Cooke's offices many times and had access to his information on the field. He eventually acquired those leases in the field that Southland rejected.

Upon finding that Hoover had acquired leases within the scope of the report for his individual benefit, Cooke brought suit to impose a constructive trust upon the leases involved. The basis of the suit was that a confidential relationship existed between Cooke and Hoover due to many years of friendship and business and social contact. Cooke also contended that the report was for the exclusive use of Southland Royalty Company and was not to be used by Hoover individually.

In reversing the trial court, the court of appeals held that no confidential relationship existed between the parties; the relationship between them was not of the type that would give rise to a constructive trust. The court pointed out that trust in the context of a moral, social, domestic, or purely

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56. 566 S.W.2d 19 (Tex. Civ. App.—Corpus Christi 1978, writ ref'd n.r.e.).

personal relationship does not normally transform the relationship into one of trust and confidence for purposes of imposing a constructive trust. The court further noted that both parties were experienced businessmen on an equal footing in education, ability, experience, and business acumen, and in such circumstances each party must exercise due care for the protection of his own interests.

### III. REGULATION CASES

In *Railroad Commission v. Graford Oil Corp.*<sup>57</sup> the Texas Supreme Court affirmed the judgment of the district court of Travis County invalidating an order of the Texas Railroad Commission. The Commission's order had consolidated nine gas fields into one field for spacing and proration purposes, setting 320-acre proration units with a 100 percent acreage allowance. Upon the application of Mitchell Energy Corporation<sup>58</sup> for consolidation of the fields, notice of a hearing was given to operators of record of affected land, but no notice was given to owners of unleased lands that were affected. About seventy-five owners of these unleased lands intervened.

The order was first remanded by the district court on the ground that the order was not supported by findings of fact and conclusions of law as required by section 16(b) of the Texas Administrative Procedure Act.<sup>59</sup> The Commission then issued a second order that was identical to the first with the exception that the required findings were made. Graford and the intervening landowners brought a second appeal to the district court, which found the order invalid on the following grounds: the order did not contain fact findings that the hydrocarbons it affected constituted one common reservoir; there was no substantial evidence to support such a finding; and, the owners of unleased property affected by the order had been deprived of property rights without due process of law when denied the right to intervene in the hearing before the Commission. The Railroad Commission and Mitchell appealed directly to the Texas Supreme Court, which affirmed on all counts.

The Railroad Commission and Mitchell claimed that the statutory definition of a common reservoir, that which "appears to be underlaid by a common pool or accumulation of oil and/or gas,"<sup>60</sup> should be construed as meaning that which "appears to be underlaid by a common pool or *[by an] accumulation of oil and/or gas.*"<sup>61</sup> The supreme court disagreed with the latter interpretation, holding that in the statute the word "common" modified both "pool" and "accumulation."

The court defined a common reservoir as one in which all producing

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57. 557 S.W.2d 946 (Tex. 1977).

58. Mitchell Energy Corporation is involved in several of the cases reviewed in this Article. See cases discussed in text accompanying notes 23 & 37 *supra* and 65 *infra*.

59. TEX. REV. CIV. STAT. ANN. art. 6252-13a, § 16(b) (Vernon Supp. 1978-79).

60. *Id.* art. 6008, § 2(c) (Vernon 1962) (repealed 1977).

61. 557 S.W.2d at 950 (emphasis added).



areas are in natural communication. The facts as found by the Commission showed that the completed wells furnished the only communication between the vertically-separated producing areas; thus, they did not form a common reservoir.

The court further noted that the appeal procedure did not afford an adequate remedy for the owners of the unleased lands who had not appeared before the Commission. These persons had property rights that might be adversely affected and that were different from those asserted by other parties appearing before the Commission. The denial of the right to appear at the Commission hearing was effectively a denial of the opportunity to be heard on the real decision-making level because the trial court in Travis County is powerless to substitute its judgment for that of the Commission; it cannot enter what it might believe to be a correct order, but can only remand to the Commission.

In *California v. Southland Royalty Co.*<sup>62</sup> the United States Supreme Court reversed and remanded the Fifth Circuit's decision in *Southland Royalty Co. v. FPC*,<sup>63</sup> which had held that gas that had been dedicated into interstate commerce under oil and gas leases with a fixed fifty-year term ceased being so dedicated upon the termination of the leases. The ground for the Fifth Circuit's holding was that since the lessee's rights in the gas under the leasehold lands could not survive the termination of its fifty-year lease, it could not create rights in a third person to that same gas beyond the fifty-year period.

The Supreme Court reversed on the ground that once gas was dedicated into the interstate market under an unlimited certificate of convenience and necessity, the obligation to serve the interstate market continued until abandonment was authorized under section 7(b) of the Natural Gas Act.<sup>64</sup> The obligation arose as a matter of law rather than contract and was binding upon all those with dominion and power of sale over the gas, including the lessors who owned the reversion.

In *Superior Oil Co. v. Federal Energy Regulatory Commission*,<sup>65</sup> the last case noted in this section, the Fifth Circuit upheld the validity of orders of the Federal Power Commission requiring producers to report yearly detailed information relating to expenditures, exploration and development activity, production, reserve additions, and revenues. The court also held that information so submitted could be publicly disclosed even though it falls within the exclusions of the Freedom of Information Act. These exclusions merely offer exemptions from compelled disclosure; they do not prohibit federal agencies from voluntarily publishing the information.

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62. 98 S. Ct. 1955, 56 L. Ed. 2d 505 (1978).

63. 543 F.2d 1134 (5th Cir. 1976). This opinion is discussed in Hemingway, *supra* note 13, at 177.

64. 15 U.S.C. § 717f(b) (1976).

65. 563 F.2d 191 (5th Cir. 1977).

## IV. MISCELLANEOUS CASES

In *Lone Star Gas Co. v. Howard Corp.*<sup>66</sup> the courts dealt with the following favored nations clause in a gas purchase and sale agreement:

"COMPARATIVE PRICE ADJUSTMENTS: *If, at any time or times, subsequent to the date of the execution of this agreement and so long as gas is delivered hereunder, there shall be in effect any agreement between Buyer and any other producer or producers of gas providing for the purchase of gas produced in District 8 of the Railroad Commission of Texas, as presently constituted, at a price per one thousand (1,000) cubic feet higher than the price per one thousand (1,000) cubic feet, payable at the same time hereunder and for gas of a like character taken under substantially similar provisions relating to delivery, pressures, quantity, compression requirements, and primary terms of contract, then Buyer will thereupon increase the price thereafter payable hereunder so that it will equal the price payable at the same time under such other agreement, and such higher price hereunder shall continue in effect during the remainder of the primary term of this contract so long as any such higher price is paid for gas by Buyer under any such other agreement.*"<sup>67</sup>

The buyer entered into subsequent contracts with others that provided for higher prices to be paid for the gas purchased. The court of appeals affirmed the trial court's holding that such contracts triggered the price increase clause. The Texas Supreme Court at first granted writ in this case, but then reversed itself in a short opinion, finding that sufficient evidence supported the trial court's determination that Lone Star Gas had subsequently purchased gas of a like character, taken under substantially similar provisions. The supreme court also agreed with the court of appeals' holding that a contract containing a price increase clause was not a special contract under article 2226,<sup>68</sup> and, therefore, the trial court had correctly awarded attorney's fees to the plaintiff.

In another Texas Supreme Court case, *Cohen v. McCutchin*,<sup>69</sup> the question presented was whether two letter agreements providing for the assignment of part of the working interest in leases and the proportionate sharing of drilling and completion costs satisfied the Statute of Frauds<sup>70</sup> so as to support a suit brought by the estate of the assignor. The letter agreements were neither signed by the assignor, written on his letterhead, nor otherwise identified with him. The trial court entered a summary judgment that the estate of the assignor take nothing in its suit, a judgment affirmed by both the court of appeals<sup>71</sup> and the Texas Supreme Court.

The administrator of the assignor's estate asserted that the court also should have considered both the transmittal letter that accompanied the

66. 556 S.W.2d 372 (Tex. Civ. App.—Texarkana 1977), writ *ref'd n.r.e. per curiam*, 568 S.W.2d 129 (Tex. 1978).

67. 556 S.W.2d at 374 (emphasis added by the court).

68. TEX. REV. CIV. STAT. ANN. art. 2226 (Vernon Supp. 1978-79).

69. 565 S.W.2d 230 (Tex. 1978).

70. TEX. BUS. & COM. CODE ANN. § 26.01 (Vernon 1968 & Supp. 1978-79).

71. 554 S.W.2d 844 (Tex. Civ. App.—Waco 1977).

checks used for partial payment of the drilling costs of the well and the check stubs themselves. The supreme court held that these writings also failed to identify the assignor as a party to the agreements. The court stated:

This statute requires that, with respect to the agreements defined therein, there must be a written memorandum which is complete within itself in every material detail, and which contains all of the essential elements of the agreement, so that the contract can be ascertained from the writings without resorting to oral testimony.<sup>72</sup>

#### V. LEGISLATION

The only significant legislative enactments affecting oil and gas were two amendments to the Water Code, providing for: (1) a Deepwater Port Authority to develop an offshore port for the accommodation of supertankers importing crude oil and other liquified petroleum products;<sup>73</sup> and (2) the issuance of temporary water permits for the use of water in oil and gas drilling operations.<sup>74</sup>

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72. 565 S.W.2d at 232.

73. TEX. WATER CODE ANN. §§ 19.001-149 (Vernon Supp. 1978-79).

74. 1977 Tex. Sess. Law Serv. ch. 152, § 1, at 319 (amending TEX. WATER CODE ANN. § 5.137(a)).